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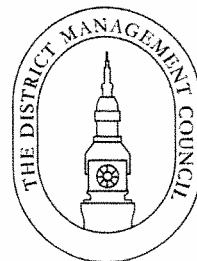
## Pay-for-Performance Programs: Strategies, Structures, and Funding

DMC Spotlight

by Nicholas P. Morgan and Daniel Schiff

### TO ORDER

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# Pay-for-Performance Programs: *Strategies, Structures, and Funding*

Many questions arise when the topic of performance pay is raised. Haven't we tried this before? Why should we try to differentiate compensation when public educators earn too little as it is? Aren't teachers motivated primarily by intrinsic factors anyway? Don't these plans breed a sense of competition rather than cooperation among teachers? Is there any "proof" that this works? Despite ongoing debate on these questions, school districts and policymakers alike are pursuing a variety of differentiated compensation approaches to affect school district operations. In this DMC Spotlight, we focus on strategies, structures, and funding for performance-based compensation programs – factors critical to designing and implementing a program appropriate to your district.

NICHOLAS P. MORGAN AND DANIEL SCHIFF

## The Context of Differentiated Compensation

Over the past two decades, the United States has embarked on a broad-based campaign to enhance educational performance through standards-based reform, greater focus on accountability, and a renewed commitment to invest in the American public school system. Recognizing that teacher effectiveness is the most important determinant of student achievement, educational leaders have pursued a broad variety of initiatives to improve the teacher workforce. In this new environment, establishing performance-based teacher compensation systems has been increasingly viewed as a viable strategy to enhance the appeal of teaching careers, retain quality instructors, and boost teacher effectiveness. Accordingly, scores of school districts and states across the nation are now grappling with the development, implementation, and sustainability of such performance pay programs.

Historically, the American public education system has employed a number of different compensation models. In the nineteenth century, the predominant compensation structure was the "position-based" or "graded pay" salary system, under which individual teachers negotiated contracts with principals, teacher pay varied significantly

by grade and assignment, and women (mostly relegated to elementary schools) and minority teachers were paid less than non-minority male teachers.<sup>1</sup> Its successor, the "single salary schedule," a more objective compensation structure whereby classroom teachers were assigned salary classifications based on their teaching experience and educational attainment, arose in the early twentieth century. Today, the single salary schedule remains by far the dominant compensation system in the American public education system, with approximately 93% of all school districts utilizing the system to determine teacher compensation.<sup>2</sup> Indeed, among districts with over twenty schools, the single salary schedule is virtually universal.<sup>3</sup>

After a wave of "merit pay" initiatives in the 1980s and early 1990s, which failed, for the most part, due to poor funding, structure, and implementation, the country is again embracing compensation reform.<sup>4</sup> True performance-based compensation systems, however, remain a relatively rare phenomenon in American education. Recent data is scarce, but according to one study in 2004, less than eight percent of school districts claimed to use pay incentives (including cash bonuses, salary increases, and/or movement on a salary schedule) to reward "teaching excellence" – a category corresponding to performance-, knowledge-, and skill-based compensation.<sup>5</sup> ▷

And, in reality, only a small fraction of these districts actually employ a true performance pay system.

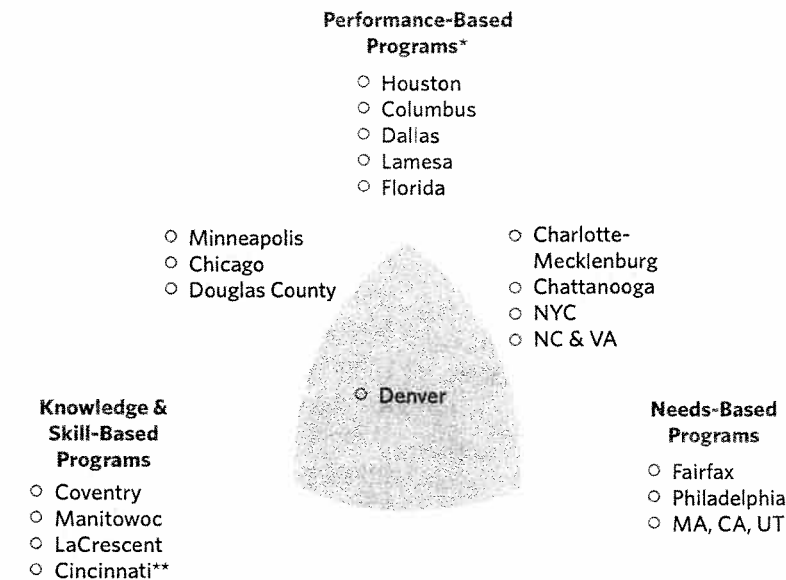
In Figure 1, we show a selection of differentiated compensation programs, organized by category. Performance-based systems use some measure of district outcomes – student achievement or some proxy thereof – to allocate incentive rewards. Skill and knowledge-based plans pay teachers extra money for factors like educational attainment or specific certification. In needs-based programs, districts provide monetary incentives to alleviate teacher shortages in selected fields and to attract educators to hard-to-staff schools. In other words, performance-based systems use results to drive compensation, while skill- and knowledge-based systems and needs-based systems use inputs to drive compensation.

## Performance-Based Compensation in the Era of Standards and Accountability

Over the past 15 years, increasing numbers of public school districts and state governments have sought to promote student achievement by employing performance- and skill-based compensation plans designed to improve teaching skills, recruit talented teachers, and retain quality instructors. More recently, the federal government has entered the fray via new nationwide grant programs that offer selected school districts hundreds of millions of dollars to spur the implementation of innovative performance compensation plans. Underlying these initiatives is a growing recognition that the conventional single salary schedule compensation model is not aligned with the current performance-centered educational landscape and cannot ensure

FIGURE 1

### Differentiated Compensation Models: Not All Are Performance-based



\* Note: includes both individual- and school-based performance programs

\*\* Cincinnati plan discontinued

Source: DMC

the steady stream of high-quality teachers needed to enhance student academic achievement in the twenty-first century.

There is widespread agreement within public education that effective teachers can contribute substantially to student achievement — regardless of a child's innate abilities or socioeconomic circumstances.<sup>6</sup> Unfortunately, the prevailing teacher salary scale has no meaningful ties to the expertise and skills required in the classroom. The vast majority of public school teachers are paid based on two attributes: (1) experience and (2) educational credentials.<sup>7</sup> However, research indicates that teachers who have earned graduate degrees are not significantly more successful at increasing student learning than educators without such credentials. Likewise, research reveals that teaching experience is only faintly related to teaching quality and student achievement, and that the greatest improvements in teacher effectiveness occur during the first few years in the classroom.<sup>8</sup> Furthermore, the single salary schedule affords little flexibility to entice the most attractive candidates into teaching or to encourage the best instructors to remain in the profession. Nor does it encourage teachers to address knowledge gaps or to learn new skills that can be applied in the classroom.<sup>9</sup> In fact, the system provides an incentive for ineffective teachers to remain in the public schools by raising pay steadily over a teacher's career regardless of the quality of instruction.<sup>10</sup> As a result, districts are consuming a significant and increasing portion of their financial resources to pay for activities that have little connection to student achievement. Hence the premise for performance pay: shouldn't we align compensation to the outcomes we seek rather than to inputs that are ineffective?

### Why Performance Pay Holds Promise

Fundamentally, any proponent of performance pay needs to believe that money can help motivate some type of desired behavioral change within the district. Extrinsic motivators, like the possibility of additional income, have become ubiquitous in most other sectors of the economy through a wide variety of compensation vehicles. Research claiming teachers are only interested or responsive to "intrinsic" or environmental motivators

may be flawed due to a variety of biases.<sup>11</sup> Indeed, studies have shown strong evidence of self-serving biases when considering extrinsic motivation in several industries, including education. Many people don't like to admit they are motivated by money, even when they are.

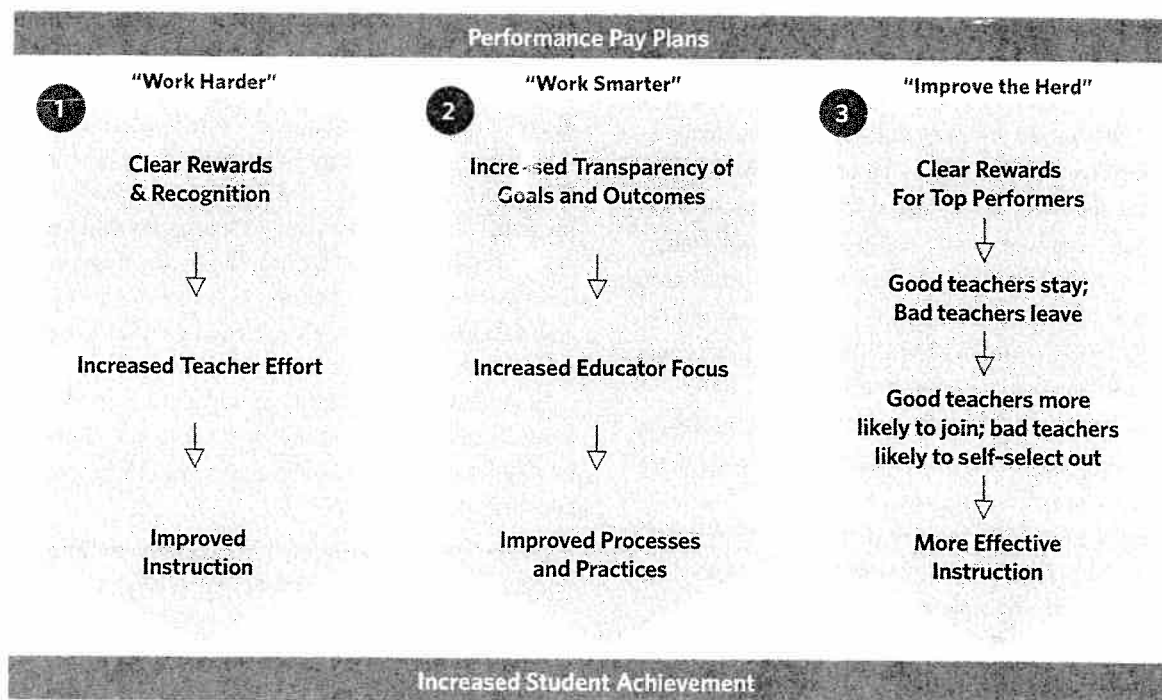
The theories of action behind performance pay can be distilled into a few discrete options, each with a differing perspective on the how the lure of money will affect motivation and drive behavioral change. Three possible theories of action are shown in Figure 2. The first, which we call "Work Harder," is the belief that the potential for additional income can drive increased workplace effort, which will in turn drive increased student achievement.<sup>12</sup> While many believe this to be a feasible theory of action for our nation's public schools, others find the notion nothing short of offensive. According to the detractors, teachers already work as hard as they can and their pay is too low to begin with.

While this first theory of action has been the focus of much of the debate around performance pay, it may ignore two very powerful additional pathways to drive student achievement. A second theory of action, which we call "Work Smarter," states that performance pay structures will yield greater focus on outcomes-driving practices to increase student achievement. Third, and also very powerful, is what we term "Improve the Herd," whereby the performance pay structure provides both monetary incentives and a culture for beneficial self-selection to occur. Better teachers will be recruited and retained, while bad teachers will self-select out.<sup>13</sup> Each of these theories of action is a potentially dramatic performance driver and all three are being tested in ongoing research activities and existing district programs.

Performance-based pay systems better align teacher compensation with the primary objectives of public school districts — improved classroom instruction and enhanced student achievement. By linking compensation to teacher performance, performance pay plans can help districts better recruit, develop, and reward talented educators. Furthermore, boosting the remuneration of top educators gives the entire teacher workforce an incentive to cultivate professional skills and practices likely to increase student achievement and promote standards-based reform.<sup>14</sup> >

FIGURE 2

## Possible Discrete Theories of Action for Performance Pay



Source: Adapted from Guthrie & Shuermann 2009; DMC analysis

Although formal research on whether performance pay improves student outcomes is still evolving, most studies to date have shown a positive impact on student achievement. Several of the most rigorous studies testing performance pay models have been international, but a number of highly regarded domestic academic studies have also shown that paying teachers based on class or school performance can significantly enhance student learning.<sup>15</sup> A study of a performance pay program in place in Tennessee during the 1980s and 1990s demonstrated that students in grades K-3 with career-ladder teachers performed substantially better in mathematics than students with other teachers.<sup>16</sup> Another study, reviewing a more recent performance-based, school-wide pay plan in Chattanooga, Tennessee, showed that the percentage of third graders reading at or above grade level increased from 22.6% in 2001 to 35.9% in 2003, outpacing non-participating city schools as well as

90% of elementary schools in the state.<sup>17</sup> Many more rigorous domestic studies are currently underway.

Moreover, district leaders have expressed enthusiasm for pay-for-performance programs — regardless of whether such plans offer rewards to teachers based on individual or school-wide success. Most superintendents believe that pay-for-performance compensation models drive student achievement, enhance teacher effectiveness, and constitute a motivational tool for educators.<sup>18</sup> District leaders do not view major stakeholders, such as school boards, local communities, or school system administrators as major obstacles in the implementation of performance-based pay programs.<sup>19</sup> Perhaps unsurprisingly, superintendents consider teacher union opposition as the largest potential impediment to the introduction of performance compensation plans — followed by concerns about the accuracy of district performance measures and the ability to link teacher evaluation and student achievement to compensation.<sup>20</sup>

## Performance Pay Rises at the District, State, and Federal Levels

In recent years, as national education priorities have focused on compliance, accountability, and student achievement, performance pay has advanced on multiple fronts. Most significantly, state governments and local school districts across the nation have implemented a wide range of performance-based compensation systems, spending an estimated \$500 million on such award programs during the 2008-2009 school year.<sup>21</sup> Leaders at the state level include Minnesota's Q-Comp Program, North Carolina's ABCs Program, Florida's Merit Award Program (MAP), and Texas' Governor's Educator Excellence Grants (GEEG) and District Awards for Teacher Excellence (DATE), with the last two comprising the largest performance pay program in American public education.

Locally-based initiatives have been very dynamic with an ever expanding number of districts introducing an eclectic mix of performance-based pay systems. Prominent among these efforts have been early innovators such as Douglas County (CO), Denver, and Houston, which have adopted and sustained differentiated pay programs ranging from more modest, largely input models to more comprehensive, output-focused plans. Alongside such well-established programs, large numbers of additional districts, including Chicago and Guilford (NC), are in the process of implementing new performance pay plans.

Over the past ten years, the federal government has emerged as an ever more important champion of performance pay programs, first with the enactment of the No Child Left Behind Act (NCLB) and more recently with federally-funded programs such as the Teacher Incentive Fund (TIF), the Institute of Education (IES), and the National Center on Performance Incentives (NCPI).<sup>22</sup> The most significant of these initiatives, the Teacher Incentive Fund, enacted in 2006, has evolved into a critical stimulus vehicle, providing hundreds of millions of dollars annually to performance compensation programs throughout the country.<sup>23</sup>

## Design Parameters for Performance Pay Systems

(Please refer to **DMC MANAGERS' TOOLKIT: How to Design a Performance Pay Program** for more information on structuring a program for your district)

The emergence of performance pay as a viable alternative compensation model forces states and school districts to confront difficult questions concerning (1) the structure, scope, and distribution of monetary rewards; (2) program financing; (3) program management; and (4) stakeholder relations. Addressing these issues is essential in order to craft and sustain an effective and equitable compensation plan aligned with district and/or state strategic objectives.

In determining the structure and allocation of financial rewards — perhaps the core components of any performance compensation system — three elements are paramount:<sup>24</sup>

- **Definition of Performance Measurement:** *Why* should awards be given? What types of performance are worthy of financial incentives? Should an achievement-based or growth/value-added model be used?
- **Reward Structure:** *What* is the award? At what organizational level (i.e., individual, department or school) should rewards be calculated and awarded? What should the amount be?
- **Participant Reward Rules:** *Who* should receive awards? Should rewards be allocated using relative rankings or standards-based thresholds? Should participants be allowed to opt in or out?

## Performance Measurement

At the foundation of any performance compensation system is the definition and design of the plan's performance measurement. When establishing a performance pay program, leaders must begin by addressing the meaning of "good performance." In short, what outcome or combination of outcomes will be rewarded?

States and school districts have a number of options in designing performance measurements. First, education leaders can create incentive programs that allocate >

rewards based on direct assessments of teacher performance and expertise. Under such a system, school systems use professional evaluations (by district administrators, principals, and/or peers) to set relative or standard measures for performance outcomes using objective and subjective observations. The evaluations employ measures linked to curriculum and instruction as a means to identify student growth and teacher proficiency.<sup>25</sup> Accordingly, teachers are rewarded for possessing classroom knowledge and teaching skills deemed critical to student achievement.

Second, districts can implement incentive plans that use student achievement outcomes to establish standard measures for performance outcomes. Indeed, performance-based compensation systems typically link teacher awards to improved academic achievement by students. Such achievement is usually defined by improved performance on standardized examinations. Some districts, however, use other benchmarks of student success, such as the attainment of more generalized annual growth objectives, to evaluate teacher performance.<sup>26</sup>

In gauging student achievement under performance pay plans, school systems can evaluate student gains by applying an “achievement” model that measures a child’s performance at a single point of time and compares that result to an established standard or threshold. Alternatively, school systems can utilize a “growth” or “value-added” model that measures a student’s progress between two different points in time and comparing the student’s current academic performance to their prior performance.<sup>27</sup> Many educators argue that the value-added model represents the more equitable approach, asserting that progress metrics – unrelated to pre-existing factors – better reflect the real impact teachers and schools have on students’ academic performance. To minimize perceived unfairness, many performance-based pay programs, including the Houston program, have adopted a value-added approach that focuses on year-to-year student improvement rather than the level of absolute achievement.<sup>28</sup>

### **Reward Structure**

This second element forces districts to define the structure of incentive rewards. As an initial matter, the school system must decide at what organizational level

awards should be calculated and awarded. Individual-based awards reward teacher performance, which is evidenced by improved student achievement and/or strong instructional ability at the classroom level. Such payouts provide the most formal linkage between individual compensation and performance and are likely to improve teacher proficiency. However, individual-based awards may reduce faculty cooperation.<sup>29</sup>

Group awards, typically computed and conferred at the school-level, provide payments for school-wide academic success or the attainment of valued non-academic outcomes (i.e., increased graduation rates). Incentive awards may also be aggregated at the department or grade level for secondary school teachers, as individual teacher-level data often cannot be calculated for such educators.<sup>30</sup> Group awards establish a strong linkage between compensation and school performance while also promoting collaboration among instructors. However, such payments can create free rider problems and demotivate top performers.<sup>31</sup>

Districts must also determine which district employees will be eligible for rewards under a performance-based program. Will the plan be limited to core teachers or include other personnel, such as teaching assistants and instructional and non-instructional support staff? Denver, Austin, and Florida, for example, limit participation to teachers, while Toledo (KS) and North Carolina expand eligibility to all certified school staff, and programs in Houston and Dallas include all campus personnel.<sup>32</sup>

In contemplating reward structures, school systems must also determine the appropriate size of incentive payments. District leaders should strive to offer sufficiently large awards to motivate teachers (and other employees) to change behavior successfully. Towards this end, bonuses can be structured as a percentage of teacher base pay or as a defined payout significant to the potential recipient. In recent years, a number of districts, most notably Houston, have raised incentive awards and provided teachers with a real opportunity to earn bonuses equal to 20 percent of base salary.<sup>33</sup> However, other districts plans, while purporting to offer large bonus payouts via an array of incentivized activities, make it very difficult for teachers to earn the maximum notional award in reality.<sup>34</sup>

To minimize institutional disruption and garner approval from often skeptical educators, most districts have designed incentive payments as an extension or adjunct to preexisting salary schedules – not as replacements for such schedules. Accordingly, most performance plans have historically provided relatively limited performance compensation – typically a few thousand dollars or a sum representing less than 10% of a teacher's base compensation under the prevailing salary schedule.

### ***Participant Reward Rules***

This last design parameter forces districts to define who will be eligible for rewards. The key question for districts to address here is whether the award will be based on a relative measure or on an absolute standard. Relative measures might award bonuses to the top quartile or half of a given group for example, whereas an absolute policy would award bonuses to anyone who has achieved a defined minimum performance hurdle. Each model has distinct pros and cons that may be more or less important depending on the individual district.

The relative measure provides a significantly more predictable model to manage financially because leaders can set in advance how many people will receive rewards, thereby allowing total costs to be calculated.<sup>35</sup> Only a fixed number of people will access the bonus pool, so logic dictates that those motivated by additional money will compete for the limited award slots. The relative model is often thought to be more competitive in nature.

The absolute model offers the financially riskier approach of incentivizing as many people as possible to pass a certain level of performance. Total costs will therefore increase along with increased performance. If the district has limited predictive ability about performance gains, the financial uncertainty may be significant.<sup>36</sup>

However, the absolute model allows anyone to exceed the hurdle, so cooperation should be encouraged for the possibility of mutual benefit. This model places no limit on the number of program awards — potentially imposing a crippling financial burden on some school districts. As with each of the design elements, there is no one right answer. Districts should consider their local context carefully and pursue design choices that best fit their prevailing cultural and operating environment.

### **Performance Pay Programs in Action**

Current performance pay programs represent a broad range of configurations. Douglas County (CO) primarily measures performance via professional evaluation of teacher knowledge, skill, and expertise. Other schools systems, such as Houston and Guilford County (NC), judge teachers entirely on the basis of student academic performance.<sup>38</sup> Incentive pay plans in Minnesota (Q-Comp) and Hillsborough County (FL) focus awards on individual educators while programs in Texas (GEEG), North Carolina (ABCs), and Toledo (KS) mete out rewards based solely on school-wide performance.<sup>39</sup>

Most prominent performance pay plans utilize multiple strategies. Douglas County, Austin, and Minneapolis have developed compensation plans with student achievement and teacher evaluations and/or teacher skills as performance benchmarks. Denver's renowned ProComp program – one of the most diverse pay plans – blends (1) performance-based rewards for improved student academic achievement and successful professional evaluations with (2) knowledge and skill-based incentives for licensures, certifications, and professional development with (3) “needs-based” bonuses for serving in underperforming schools and teaching hard-to-staff specialties.<sup>40</sup>

The Douglas County Performance Pay Plan, designed as part of an economic partnership between the Douglas County School District (DCSD) and its teacher workforce, has been in place for over 15 years and remains one of the best known performance compensation programs in America. With the launch of the plan in 1994-95, DCSD became one of the first schools systems in the nation to implement a comprehensive incentive plan. While preserving a base salary schedule, the Douglas County Performance Pay Plan has superimposed both knowledge- and skill-based pay and group-based performance pay onto the district's compensation structure. Notably, the performance-based components use professional evaluations, along with student achievement results, to decide which teachers merit awards.<sup>41</sup>

Taken together, the various incentive bonuses included in the program could, in theory, constitute as much as 12% of an individual teacher's compensation.<sup>42</sup> In reality, however, aggregate variable pay accounts for well under two percent of total teacher compensation >



in Douglas County. During the 2002-03 school year, for example, the average bonus awarded to DCSD teachers was only \$446 – representing barely one percent of the average base salary in the district.<sup>43</sup> However, from its commencement, Douglas County's variable compensation program won widespread support from district teachers, and that support has not dissipated over time.<sup>44</sup> District educators have voted to continue the DCSD's variable compensation system each year since its inception.

As a more recent point of comparison, the Denver Public Schools (DPS) "ProComp" plan is a more extensive overhaul than the differentiated pay plan introduced a decade earlier in Douglas County. Denver is the first major city in America to design and implement a teacher compensation system providing pay for performance – with student achievement results constituting a key award component. Denver's ProComp system supplanted a single salary schedule granting teachers automatic pay increases based on years of service and educational attainment with a new pay system providing teachers with multiple opportunities to augment their compensation. The district's ProComp compensation program encompasses four separate components: (1) Student Growth, (2) Professional Evaluation, (3) Knowledge and Skills, and (4) Market Incentives.<sup>45</sup> In an effort to make ProComp more appealing (and less intimidating) to Denver educators, teachers employed by the district at the time of the program's implementation have the option of remaining under the traditional pay structure for the remainder of their careers or opting into the new system at any time during its first seven years of operation. Since 2006, however, new teachers have been automatically enrolled into the new compensation program.<sup>46</sup>

In the past, even districts with diverse incentives have been cautious about deploying the most contentious aspects of performance pay. Compensation plans in which monetary rewards are highly correlated to improvements in standardized test scores have often generated controversy because of longstanding teacher discomfort with using such exams as an assessment instrument. Student-driven performance rewards in districts such as Douglas County and Charlotte-

Mecklenburg are awarded on the basis of school-wide (as opposed to classroom-based) outcomes and not exclusively centered on standardized test results.<sup>47</sup> The hybrid compensation plan instituted in Denver, likewise, uses student standardized exam scores as only one of multiple criteria in determining annual performance payments to teachers.<sup>48</sup>

In sum, forward-thinking districts across the nation have adopted different approaches to performance compensation. However, neither research nor operational experience has yielded definitive insights regarding a superior incentive compensation model. A "one-approach-fits-all" compensation solution doesn't exist. Plans should be designed based on a school system's strategic objectives and appetite for change as well as the district culture and political landscape.

### Financing Performance Pay Programs

Districts are advised to adhere closely to a set of management and financing principles intended to maximize the long-term viability of incentive pay plans. Among these core principles is financial sustainability. Procuring sufficient and stable funding for performance pay systems has been critical to the survival of such plans. Indeed, past experience reveals that few deficiencies will undermine performance pay initiatives more quickly than a failure to honor financial commitments.

Unfortunately, performance pay programs have proven to be quite expensive, as states and districts increasingly find that "sustainable programs are not cost neutral."<sup>49</sup> Virtually no school district has sought to abandon the traditional single salary schedule in favor of a completely performance-driven model. Rather, modern differentiated pay plans have generally offered performance-based bonuses and salary hikes as a supplement or adjunct to compensation due under the district schedule.<sup>50</sup>

Given that instructional costs account for nearly half of total public school expenditures and that performance-based awards can constitute anywhere from one to twenty-five percent of an educator's base salary, the cost of program rewards can run into the tens of millions of dollars in larger school systems.<sup>51</sup> Indeed, for the 2008-09 school year, Houston's ASPIRE program ▷

*(continued on page 41)*

paid over \$40 million in bonus awards to district teachers and support staff.<sup>52</sup> In those districts, such as Denver, where performance payments are incorporated into future base salaries, the costs of such awards will be compounded year-over-year for the remainder of the teacher's career. Moreover, to the extent that incentive payments increase total compensation for educators, districts expand their future pension obligations.

Increased compensation expenditures, however, are far from the only incremental costs sustained by differentiated compensation programs. From the outset, school systems incur significant research and design costs to determine the structure and operation of the plan. Once the incentive compensation program is implemented, districts will likely have to expend additional money to staff and operate new assessment and data collection systems.<sup>53</sup> In conjunction with these efforts, districts may need to update and expand their existing technological infrastructure – a costly process that may significantly boost capital expenditures. Furthermore, calculating, awarding, and disbursing reward payments will necessitate new accounting and payroll procedures, thereby increasing administrative costs.<sup>54</sup>

Four categories of revenue finance the vast majority of performance pay expenditures in the United States: (1) district funding via local taxes, (2) state funding via grants and appropriations, (3) federal grants, and (4) philanthropic and corporate support (See Figure 3). Over the years, leading districts have employed a number of opportunistic strategies to take full advantage of these potential revenue streams.

### 1. Accessing District Resources

District general funds provide the most significant funding source for local differentiated pay plans. Districts can reallocate existing resources into the program, often through the redeployment of funding within the future compensation structure – a process whereby monies previously set to be allocated to teachers for graduate degrees, certifications, and increased experience (step expenditures) are instead redistributed to performance-based initiatives.<sup>55</sup> Indeed, Houston recently adopted this strategy to provide internal funding for the ASPIRE pay plan, redirecting one percent of scheduled salary raises toward funding its performance pay plan,

and thereby effectively reducing a hypothetical three percent raise to two percent. The decision generated approximately \$8 million per year, a sum sufficient to fund a significant portion of the increase in payouts to teachers and support staff.<sup>56</sup>

Alternatively, districts can attempt to reallocate resources from outside the compensation structure by adopting a more aggressive stance with respect to program evaluation and prioritization. Under this approach, school systems redeploy money from lower value, underutilized, and/or redundant district programs to performance pay plans.<sup>57</sup> Finally, districts can raise internal funds by expenditure reductions derived from district performance gains. For example, a successful effort to reduce absenteeism will increase the school system's overall financial performance by, among other things, decreasing payments to substitute teachers, lowering administrative and recruitment costs, avoiding loss of instructional continuity, and reducing the time needed for classrooms to achieve curriculum objectives. The resulting monetary savings can be used to support performance pay initiatives.

### 2. State Grants and Appropriations

State grants and appropriations are a common source of external funding for district performance pay programs. However, while it substantially supplements district resources, state aid is inherently less controllable and dependable than internal funding. First, state assistance is often accompanied by specific provisions that dictate or restrict how funds may be spent, thereby potentially limiting the ability of central offices to utilize such money to advance plan objectives. More importantly, however, state appropriations and grants are dependent on the whims of the legislature, which, subject to prevailing economic conditions and the political vagaries of the moment, normally have to approve disbursements on an annual basis.<sup>58</sup>

Some state legislatures have provided a more reliable stream of funding by subsidizing compensation plans via categorical aid statutes rather than annual grants. For example, Minnesota state officials structured their Q-Comp pay plan as a categorical aid program funded through a permanent line item in the state budget.<sup>59</sup> Accordingly, Q-Comp's funding is now a part of the >

state's baseline commitment to education financing and not a discretionary funding program. Yet, even institutionalized, supposedly "permanent" funding is ultimately subject to the decisions of current and future legislatures.

### 3. A Growing Wave of Federal Assistance

Until relatively recently, the federal government's involvement with performance-based pay was largely confined to Title II, which specifically mentions the development of new forms of teacher compensation

and allows states and districts to use funding for compensation reform.<sup>60</sup> However, despite such financial flexibility, districts have rarely allocated Title II funds to incentive pay plans, preferring instead to spend such money on other programs such as class-size reduction initiatives.<sup>61</sup>

Within the past few years, however, the federal government has become an increasingly significant source of funding for state and district performance-based compensation programs. Underlying this development was the creation of the Teacher Incentive Fund (TIF) in 2006. TIF supports a variety of performance-

FIGURE 3

### Strategies for Funding Performance Pay Programs

#### Plan Cost Categories

Implementation expenses  
via research and  
design expenditures

Staffing and operations  
of new assessment and  
data collection systems

Expanded pension  
obligations

Increased annual bonuses  
paid to educators, staff

Increased administrative  
costs via accounting and  
payroll procedures

Updating technology  
infrastructure

Public relations & media  
campaigns

#### District Budget Impact



#### Primary Funding Sources

##### Federal Grants

#### Enhance Revenue By

- Advocating for enactment of categorical aid statutes providing permanent funding

##### State Grants & Appropriations

- Repackaging state and federal aid programs
- Lobbying state legislatures to increase district general fund revenues

##### Alternative Public Funding

- Securing dedicated local sales and/or property tax levies

##### Redeployment of Current District Funds

- Transferring funds from programs and services that have not demonstrated increased academic achievement

##### Philanthropic and Corporate Support

- Local business organizations
- Foundation grants

Source: DMC

based compensation systems that reward educators for increases in student achievement and boost the number of effective instructors in high-need schools.<sup>62</sup>

The federal TIF grant program is primarily intended to support teacher compensation reform during the development and implementation phase.<sup>63</sup> To qualify for TIF money, applicants must proffer sufficient evidence of existing support for compensation reform (or a strategy to generate such support) so as to ensure that district stakeholders have a long-term commitment to the effort. School systems must also specify the length of time required to develop and implement their incentive pay plan.<sup>64</sup>

Designed with the goal of promoting sustainable performance-based pay systems, TIF does not provide districts with an open-ended funding commitment. Once approved, TIF grants are available for a maximum of 60 months, funded in installments based on the district's annual progress.<sup>65</sup> Even during this five-year window, TIF includes broad cost-sharing provisions, requiring that each year districts provide an increasing share of the plan's funding from sources other than TIF grant monies. Accordingly, during the fifth and final year of the grant, a district must ensure that at least 75 percent of performance compensation expenditures are derived from non-TIF funds.<sup>66</sup>

Over the course of a few years, TIF has become a well-funded program with a substantial footprint. In 2009, TIF's initial budget of \$97 million was supplemented by \$200 million in additional funding from the American Recovery and Reinvestment Act.<sup>67</sup> By the fall of 2009, TIF had disbursed dozens of grants to districts, states, and charter schools across the nation, with annual payouts ranging from less than \$500,000 to more than \$20 million per grantee.<sup>68</sup> In December 2009, President Obama signed a bill providing for a dramatic increase in TIF funding to \$400 million in fiscal year 2010.<sup>69</sup> In future years, however, the expansive TIF program is likely to be surpassed by the even more far-reaching \$4.35 billion Race to the Top Fund — one of the largest ever federal investments in school reform — which has provisions that further expand performance-based pay.<sup>70</sup>

#### 4. Philanthropic and Corporate Support

The private sphere offers another ample source of money for performance pay plans via philanthropic and corporate support. In recent years, numerous national and regional foundations, including the Gates Foundation, the Broad Foundation, and the Walton Family Foundation, have declared performance pay as one of their funding priorities.<sup>71</sup> Such educational philanthropy has commonly taken the form of "venture capital," as foundations provide crucial early stage funding during a pay program's development and transition phases.<sup>72</sup> In Denver, for example, the Rose Community Foundation, the Broad Foundation, and Daniels Fund combined to offer more than \$4 million to fund ProComp research and development and the Pay-for-Performance Pilot. Thereafter, the three foundations provided millions more to help fund the transition from the existing system to ProComp.<sup>73</sup>

School systems may likewise procure funding support from munificent businesses within the district. Indeed, districts as diverse as Guilford County (NC) and New York City have established business-education partnerships to secure corporate assistance for their performance pay programs. Guilford County, for example, formed a partnership with the University of North Carolina system and Action Greensboro — a coalition of local foundations and businesses. In 2006, the partnership provided a \$2 million grant to Guilford to expand its "Mission Possible" program, which offers \$10,000 recruitment bonuses to eligible math and ELA teachers working in designated low-performing schools and up to \$4,000 in performance pay if students meet academic growth targets.<sup>74</sup>

#### 5. Establishing Dedicated Funding Sources

In today's difficult economic environment, school systems often lack the ability to redeploy substantial existing district revenue to incentive pay programs. Moreover, while external financing options (including state, federal and philanthropic grants) may provide useful short and intermediate-term funding for the early stage development and implementation of compensation plans, they do not necessarily offer the long-term reliability essential to sustain salary increases and recurring bonus awards. ▸

Accordingly, districts are probably best served by securing a permanent source of public funding insulated from political change and cyclical variations in educational resources and specifically dedicated to covering the costs of incentive pay programs. Such funding has often been generated via special sales and property tax levies. In Arizona, the Classroom Site Fund (CSF) was established by the voter-approved Proposition 301, which increased the state sales tax by 0.6 percent for twenty years and directed that the tax receipts be spent on educational programs.<sup>75</sup> The Classroom Site Fund receives hundred of millions of dollars of annual funding from both the sales tax and growth in K-12 state trust land revenues to support pay for performance programs throughout Arizona. State legislation protects CSF resources by requiring that the money "supplement, not supplant" teacher compensation funding from other sources.<sup>76</sup> Furthermore, state law mandates that school districts allocate 40% of their CSF revenues for performance-based pay increases for teachers.<sup>77</sup>

In Denver, a local property tax increase approved by city residents in 2005 is earmarked exclusively to support ProComp. The annual mill levy override provided Denver with approximately \$31 million in incremental tax dollars and interest earnings in 2007-08.<sup>78</sup> Importantly, the city has implemented institutional and legal safeguards to protect ProComp funds once they are collected. The property revenues are deposited in the ProComp Trust, which is administered by a trust board and subject to a comprehensive trust agreement that dictates proper use and protection of compensation funds.<sup>79</sup>

However, in the absence of such dedicated funding sources, the best way to maximize revenues and ensure the long-term sustainability of incentive pay programs is through the adoption of a diversified funding strategy. Such an approach looks to combine multiple funding streams in order to reduce the volatility produced by overdependence on any one revenue source.

## Implementation Insights

Implementing a performance-based compensation program should be a collaborative effort that incorporates teachers, administrators, school board members, parents, and the general public. School systems need to include these stakeholders in the development process, allowing all parties to play a meaningful role in district discussions and planning, and ensuring these groups

have a substantive opportunity to shape and steer the program.<sup>80</sup> Involving stakeholders in the design and implementation process increases the likelihood that the program will maintain widespread support in the face of inevitable challenges and obstacles. After the pay program has been formulated, districts must undertake a significant campaign to publicize and promote the plan while continuing to communicate and solicit feedback from all key stakeholders.<sup>81</sup> Before full rollout of a performance-based pay program, the district must strive to educate all parties on the structure and operation of the new compensation model – including rewards and performance measures – and why the new approach is appropriate. For further commentary and analysis on implementation processes, please see the case study on Houston Independent School District (HISD) in this issue. □



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